
January 2010

DEFENSE CONTRACTING

Recent Law Has Impacted Contractor Use of Offshore Subsidiaries to Avoid Certain Payroll Taxes



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Highlights of GAO-10-327, a report to congressional committees

Why GAO Did This Study

Many federal contractors establish offshore subsidiaries to take advantage of labor and market conditions. GAO has found that they also use offshore subsidiaries to reduce their U.S. tax burdens. In 2008, Congress passed the Heroes Earnings Assistance and Relief Tax (HEART) Act which resulted in contractor offshore subsidiaries paying certain payroll taxes for U.S. personnel working abroad.

Fiscal year 2009's National Defense Authorization Act required GAO to report on the rationales, implications, and costs and benefits of defense contractors' use of offshore subsidiaries. We (1) assessed trends and purposes for contractors' offshore subsidiaries; (2) identified how contractors use subsidiaries to support defense contracts; (3) assessed DOD's oversight of contractors' use of offshore subsidiaries.

To conduct our work, we reviewed data for the 29 U.S. publicly traded contractors with at least \$1 billion in DOD spending in fiscal year 2008, reviewed several illustrative contracts selected based on categories of DOD services most often performed overseas, reviewed audit documents, and interviewed DOD officials about oversight.

What GAO Recommends

Congress should consider whether further legislative action is needed to address contractor avoidance of unemployment taxes for U.S. workers.

[View GAO-10-327 or key components.](#)
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DEFENSE CONTRACTING

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What GAO Found

Many of the top 29 U.S. publicly traded defense contractors—those with \$1 billion or more in DOD contracts in fiscal year 2008—have created offshore subsidiaries to facilitate global operations. Between fiscal years 2003 and 2008, they increased their use of these subsidiaries by 26 percent, maintaining at least 1,194 in 2008. We interviewed 13 of the 29 contractors based on a range of the amount of government work, locations of subsidiaries, and industry types; they reported that 97 percent of the subsidiaries generally supported global commercial and foreign government clients, while the remaining 3 percent supported DOD contracts performed overseas. These subsidiaries also helped the 29 contractors reduce taxes, with about one-third decreasing their effective U.S. corporate tax rates in 2008 in part through the use of foreign affiliates, lower foreign tax rates, and indefinite reinvestment of foreign income outside of the United States.

For five of the DOD contracts we reviewed, companies principally used offshore subsidiaries to hire U.S. workers providing services overseas on U.S. government contracts in order to avoid Social Security, Medicare—known as Federal Insurance Contributions Act (FICA)—and other payroll taxes. This practice allowed contractors to offer lower bids when competing for certain services and thereby reduce costs for DOD. Our analysis of two contracts showed that the use of offshore subsidiaries saved DOD at least \$110 million annually prior to the HEART Act, through payroll tax avoidance. While this practice provided contract cost savings for DOD, it resulted in these companies avoiding payroll taxes that would have contributed to the Social Security and Medicare Trust Funds. The 2008 HEART Act resulted in offshore subsidiaries of U.S. companies paying FICA taxes for U.S. workers performing services overseas on U.S. government contracts. As a result, in fiscal year 2009, four of the case study contractors using offshore subsidiaries to support DOD work requested reimbursement from DOD of at least \$140 million for new FICA payments. Federal and state unemployment payroll taxes, however, were not covered by the HEART Act, and several contractors that used offshore subsidiaries have continued to avoid these taxes. In one state, we reviewed documentation for about 140 former employees of several contractors who were denied unemployment benefits in 2009. State workforce officials indicated these benefits were denied because the employees worked for a foreign subsidiary and not an American employer.

DOD officials were aware of the roles offshore subsidiaries played in the DOD contracts we reviewed and stated that oversight mechanisms, such as the Defense Contract Audit Agency's reviews of incurred costs and oversight documents, inform them of the activities of offshore subsidiaries. In contracts we reviewed, evidence of offshore subsidiaries was present in contractor labor rates, cost accounting disclosures, and contractor price proposals. Contracting officials stated that the use of offshore subsidiaries did not negatively impact contract schedule or performance.

Contents

Letter		1
Background		3
Top Defense Contractors Increased Offshore Subsidiary Use to Support Global Commercial Activities and Benefit from Reduced Liabilities		5
Offshore Subsidiaries Supporting DOD Service Contracts Overseas Were Principally Used to Avoid Payroll Taxes		7
Contractors' Use of Offshore Subsidiaries Did Not Impede DOD's Contract Oversight		14
Conclusion		16
Matter for Congressional Consideration		16
Agency Comments and Our Evaluation		16
Appendix I	Scope and Methodology	19
Related GAO Products		23
Tables		
Table 1: Comparison of Top 25 Defense Contractors' Subsidiaries in 2003 and 2008		5
Table 2: Contractor and Subsidiary Information for Six Case Study Defense Contracts		9
Table 3: Notional Comparison of Selected Payroll Taxes Paid by Employer for an Employee Earning \$100,000 in Wages		14
Table 4: DOD Contractors Interviewed and Their Fiscal Year 2008 DOD Contract Obligations		21
Figure		
Figure 1: Example of Contractor Process for Hiring U.S. Personnel through Offshore Subsidiaries for DOD Work Overseas Prior to the HEART Act		11

Abbreviations

CAS	Cost Accounting Standards
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DOD	Department of Defense
FAR	Federal Acquisition Regulations
FICA	Federal Insurance Contributions Act
FPDS-NG	Federal Procurement Data System—Next Generation
HEART Act	Heroes Earnings Assistance and Relief Tax Act
SEC	Securities and Exchange Commission

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**United States Government Accountability Office
Washington, DC 20548**

January 26, 2010

Congressional Committees

Many federal contractors operate globally through offshore subsidiaries to take advantage of favorable labor and market conditions. GAO and others have found that contractors also use offshore subsidiaries to reduce U.S. taxes and maintain subsidiaries in tax haven and financial privacy jurisdictions.¹ Congress included a provision in the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 that addressed concerns about contractor use of offshore subsidiaries to minimize U.S. taxes. This provision resulted in foreign subsidiaries of U.S. companies working on U.S. government contracts being required to pay certain payroll taxes.² The Department of Defense (DOD) relies heavily on federal contractors to support its missions and in fiscal year 2008 spent approximately \$396 billion on contracts for products and services. DOD uses thousands of contractor employees to assist in operations around the world to support U.S. forces deployed abroad with services ranging from security details to transportation and facility management.

The Duncan Hunter National Defense Authorization Act for Fiscal Year 2009 directed GAO to report on the rationale, implications, and costs and benefits for both the contractor and DOD in using offshore subsidiaries, with respect to several issues, including: tax liability; legal liability; compliance with cost accounting standards; efficiency in contract performance; and contract management and contract oversight.³ To fulfill our mandate we briefed your staffs on the results of our review. This follow-on report (1) assesses trends and purposes for defense contractors' offshore subsidiaries; (2) identifies how selected defense contractors used offshore subsidiaries to support ongoing defense contracts; and (3) assesses DOD oversight and management of defense contractors using offshore subsidiaries.

¹See GAO, *International Taxation: Tax Haven Companies Were More Likely to Have a Tax Cost Advantage in Federal Contracting*, GAO-04-856, (Washington D.C.: June 30, 2004).

²Pub. L. No. 110-245, § 302. See 26 U.S.C. § 3121(z) and 42 U.S.C. § 410(e).

³Pub. L. No. 110-417, § 844 (2008).

To conduct our work, we identified 29 U.S. publicly traded defense contractors with \$1 billion or more in DOD spending in fiscal year 2008, and reviewed information from Securities and Exchange Commission (SEC) filings to determine which of these contractors had offshore subsidiaries.⁴ From these 29 top defense contractors, we selected 13 to interview based on a range of the amount of government work in fiscal year 2008, location of identified subsidiaries, and industry type. In addition, we interviewed three other defense contractors as part of the case studies we conducted for a total of 16 contractors interviewed. We also interviewed knowledgeable attorneys, academics, and tax professionals to obtain their views about the rationale and implications of using offshore subsidiaries.

To identify examples of how contractors use subsidiaries and DOD contractor management and oversight, we identified the categories of DOD services most often performed overseas and selected six illustrative contracts as case studies based on several factors including the amount of contract dollars obligated, contracting command, and services using large numbers of U.S. personnel. For each of these contracts, we reviewed data on contractor performance and interviewed DOD oversight staff, contracting commands, and company officials responsible for these defense contracts. To determine whether contractors using offshore subsidiaries selected for case studies were subject to payroll taxes, including Social Security, Medicare, and federal and state unemployment taxes for U.S. employees, we reviewed contract file documents for the contractors and interviewed Defense Contract Audit Agency (DCAA) officials. As an illustrative example, we also selected one state, Texas, in which four of the six selected contractors had a corporate presence, and reviewed 2009 unemployment benefit claims data. We interviewed state workforce officials to determine the impact on the ability of U.S. personnel working overseas for offshore subsidiaries to claim unemployment benefits. We identified and assessed relevant laws, regulations, GAO reports, and DOD policies applicable to contractor offshore subsidiaries.

We conducted our review from February 2009 to January 2010 in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient,

⁴Throughout this report we use the terms “offshore subsidiaries” and “foreign subsidiaries” synonymously.

appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. See appendix I for more details on our scope and methodology.

Background

Our prior work has found that U.S. multinational corporations engage in offshore operations to reduce labor and administrative costs.⁵ For example, many U.S. companies have found cost efficiencies by outsourcing manufacturing jobs based in the U.S. to countries with skilled labor available at lower cost. U.S. and foreign tax regimes also influence decisions of U.S. multinational corporations regarding how much to invest and how many workers to employ in particular activities and in particular locations. Tax rules also influence where corporations report earning income for tax purposes.

We have reported on the conditions under which a federal contractor in a low-tax jurisdiction—one that has no or nominal taxes and no requirement for a substantive local presence—may have a tax cost advantage when competing for federal contracts.⁶ The extent of the advantage depends on the relative tax liabilities of the contractor and its competitors. We also previously reported that 63 of the 100 largest publicly traded federal contractors in terms of fiscal year 2007 federal contract obligations reported having subsidiaries in jurisdictions identified as tax haven or financial privacy jurisdictions.⁷

Defense contractors may contain a number of separate legal entities. A parent corporation may directly own, either wholly or partially, multiple subsidiary corporations. In turn, these subsidiaries may own other corporate subsidiaries, and any of these corporations may own stakes in partnerships. A domestic parent corporation—one that is organized under

⁵GAO, *International Trade: Current Government Data Provide Limited Insight into Offshoring of Services*, GAO-04-932 (Washington DC: September 22, 2004).

⁶GAO-04-856.

⁷Financial privacy jurisdictions are jurisdictions that have strict bank secrecy laws that persons can use to shield their wealth from taxation in their home countries. See GAO, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09-157 (Washington, D.C.: December 18, 2008).

U.S. laws—may head a group of affiliated businesses that includes both domestic and foreign subsidiaries and partnerships.

Companies also consider payroll taxes in managing offshore operations. Employers withhold these taxes from employee's wages for Social Security and Medicare and match the employee's contribution for these taxes.⁸ Workers make contributions to Social Security through payroll taxes that the Treasury credits to the Social Security Trust Fund. About 96 percent of the nation's workforce is in social security-covered employment and pays tax on its annual earnings. When workers pay social security taxes, they earn coverage credits, and 40 credits—equal to at least 10 years of work—entitle them to social security benefits when they reach retirement age. Different requirements govern the number of coverage credits necessary to receive disability and survivors benefits for workers who become disabled or die with relatively short work careers. Most employers also pay both a federal and a state unemployment tax, which provide unemployment compensation to workers who have lost their jobs. Employees in most states do not contribute to unemployment taxes.⁹

DOD uses thousands of defense contractors to provide services ranging from security details and interpreters to transportation and facility management in support of U.S. forces in contingency operations around the world. To oversee these contracts, the Defense Contract Management Agency (DCMA) is responsible for monitoring contractors' performance and management systems to ensure that cost, product performance, and delivery schedules are in compliance with contract terms and conditions. DCAA, under the authority of the DOD Comptroller, plays a critical role in contractor oversight by providing auditing, accounting, and financial advisory services for DOD and other federal agency contracts. We have reported extensively on DOD contractor management and oversight challenges in contingency operations and the need for DOD to have better contract and contractor personnel information.¹⁰ In part for these reasons,

⁸GAO, *Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes*, GAO-08-1034T (Washington DC: July 29, 2008).

⁹New Jersey, Pennsylvania, and Alaska withhold unemployment insurance taxes directly from both employees and employers.

¹⁰GAO, *Military Operations: High-Level DOD Action Needed to Address Long-standing Problems with Management and Oversight of Contractors Supporting Deployed Forces*, GAO-07-145 (Washington, D.C.: Dec. 18, 2006).

DOD contract management issues, including sufficient oversight, have been a long-standing GAO high-risk area.

Top Defense Contractors Increased Offshore Subsidiary Use to Support Global Commercial Activities and Benefit from Reduced Liabilities

From 2003 through 2008, defense contractors increasingly used offshore subsidiaries. Our analysis of SEC filings found that in 2008, 29 of the top defense contractors—accounting for 41 percent of DOD contracting dollars in fiscal year 2008—had at least 1,194 offshore subsidiaries.¹¹ Of the total offshore subsidiaries, about 200 were located in tax haven or financial privacy jurisdictions such as Singapore, Hong Kong, Ireland, or Luxembourg. Publicly traded defense contractors¹² increased their combined use of foreign subsidiaries by 26 percent from 2003 through 2008. Of these new subsidiaries, most were located in the United Kingdom and Canada, while the largest rate of growth was in the British Virgin Islands and Aruba. See table 1 for more information on the top 25 defense contractor subsidiaries.

Table 1: Comparison of Top 25 Defense Contractors' Subsidiaries in 2003 and 2008

Defense subsidiaries ^a	2003	2008	Percentage change
Offshore	928	1,169	26%
Domestic	1,533	1,472	-4%

Source: SEC 10-K filings.

^aFour of the 29 top publicly traded defense contractors in 2008 were not publicly traded companies in 2003 and, therefore, were not included in our analysis.

According to 13 of the top defense contractors we interviewed, 718 of the 738 offshore subsidiaries—or 97 percent—that they reported to the SEC in fiscal year 2008 were generally used to support global commercial clients, and foreign government contracts rather than DOD contracts. In some cases, contractors established offshore subsidiaries for market presence and proximity to customers as they thought it was important to establish a presence where they do business overseas to be more responsive to customer needs. For example, one defense contractor established subsidiaries in Singapore to assist with equipment manufacturing and

¹¹SEC requires companies to provide information on significant subsidiaries as part of their annual filings. As a result, foreign subsidiaries that do not meet the SEC reporting threshold may not be listed, and the total number of subsidiaries reported may be understated.

¹²Four of the 29 top publicly traded defense contractors in 2008 were not publicly traded companies in 2003 and, therefore, were not included in our analysis.

repairs of commercial aircraft operating throughout Asia because it is more cost-efficient than sending the aircraft back to the United States for repairs. Ten of the 13 defense contractors told us they establish or acquire offshore subsidiaries to take advantage of foreign government markets. In one case, a defense contractor explained that it created a subsidiary in the Netherlands to hire local nationals in order to win a contract with the Dutch government. Contractors also noted that, in certain circumstances, they are required to create offshore subsidiaries to comply with foreign government requirements. For example, one company told us it established a subsidiary in Bahrain to comply with Bahrainian law for doing business in that country. In another instance, one contractor said that it registered as a local company in Iraq to conduct business in compliance with Iraqi law.

Aside from taking advantage of foreign government markets for commercial work, a key benefit of using offshore subsidiaries cited by contractors and other experts we spoke with was the ability to reduce overall taxes. Several defense companies explained that the use of offshore subsidiaries in foreign jurisdictions helps them lower their U.S. taxes.¹³ For example, one defense contractor's offshore subsidiary structure decreased its effective U.S. tax rate by approximately 1 percent, equaling millions of dollars in tax savings. Our review of 2008 SEC filings for the 29 publicly traded defense companies found that approximately one-third reported decreasing their 2008 effective U.S. tax rates through the use of foreign affiliates, lower foreign tax rates, and indefinite reinvestment of foreign income outside of the United States.

Defense contractors also told us that creating subsidiaries, whether based in the United States or offshore, protects U.S. parent companies from certain legal liabilities, although company representatives said this was not a primary reason for establishing offshore subsidiaries. For example, defense companies and experts noted that subsidiary structures limit U.S. parents from liabilities related to changes in foreign law and practices. Defense contractors said an offshore subsidiary can be used to focus liability in one place, thus shielding the rest of the company from potential lawsuits because only the assets of the subsidiary would be susceptible.

¹³Tax avoidance, the act of using legally available tax planning opportunities in order to minimize one's tax liability, is permissible. Tax avoidance should be distinguished from tax evasion, which is the willful attempt to defeat or circumvent the tax law in order to illegally reduce one's tax liability.

While almost all of the 738 offshore subsidiaries were used to support commercial and foreign clients, 20—about 3 percent—were used to support DOD contracts in fiscal year 2008. However, we do not know the percentage of DOD contract dollars supporting activities of offshore subsidiaries because contract data do not capture the use of offshore subsidiaries specifically. Most of the 13 defense contractors we interviewed directed work performed for DOD in a foreign country to a company subsidiary in that country. For example, one defense contractor's German subsidiary was the prime contractor for a facility operations support services contract in Germany. Another contractor used an Australian subsidiary to support a Navy research and development contract performed in Australia. In contrast, we also identified some defense contractors that used subsidiaries registered outside the place of contract performance to support DOD service contracts abroad. These offshore subsidiaries had no staff or business activity where registered.

Offshore Subsidiaries Supporting DOD Service Contracts Overseas Were Principally Used to Avoid Payroll Taxes

The primary use of the offshore subsidiaries registered outside the contract place of performance—many of those reviewed in our six case studies—was to hire U.S. workers to perform services overseas and thereby avoid Federal Insurance Contributions Act (FICA) taxes for those employees.¹⁴ According to contractor officials, the practice used in the cases we reviewed allowed the contractor to bid lower labor costs when competing for labor-intensive DOD service contracts performed abroad. Using offshore subsidiaries also permitted contractors to avoid other payroll taxes, such as federal and state unemployment insurance. Before the HEART Act took effect in August 2008, FICA tax payments were not required for U.S. personnel working overseas on U.S. government contracts for foreign subsidiaries of U.S. companies.¹⁵ Although this practice resulted in contract cost savings for DOD, it meant that taxes

¹⁴Federal Insurance Contributions Act (FICA) tax is a payroll tax on both employers and employees to fund the Social Security and Medicare Trust Funds. Employers are required to withhold 7.65 percent of employees' covered salaries for FICA taxes, which include Social Security and hospital insurance (Medicare) taxes. U.S. employees pay FICA taxes as well. Consequently, after the HEART Act, the U.S. personnel of these foreign subsidiaries working on U.S. government contracts were also required to pay FICA taxes.

¹⁵The HEART Act amended the U.S. Code to define a foreign subsidiary of a U.S. company working on a U.S. government contract as a domestic company for certain purposes, thus resulting in the foreign subsidiary being required to pay certain payroll taxes for its U.S. workers performing services abroad on the government contract as well as requiring those U.S. workers to pay their share of the payroll taxes. The HEART Act did not address the payment of state or federal unemployment taxes for U.S. personnel working outside the United States for foreign companies.

were not paid into the Social Security and Medicare Trust Funds as they would have been had the services been provided by U.S. personnel employed by a domestic entity. Additionally, because these payments were not made, employees did not receive coverage credits—earned when workers pay social security taxes—for this work.

DOD and defense contractor officials explained that the use of offshore subsidiaries to hire U.S. workers to perform services overseas was a practice used for labor-intensive service contracts, often for work performed in countries such as Iraq, Afghanistan, and Kuwait, because of the potential for FICA cost savings. Four of the six contractors commonly used offshore subsidiaries when hiring U.S. personnel to work on U.S. government contracts beyond the contracts we reviewed.¹⁶ Defense contractor officials explained that the need for security clearances for U.S. personnel working on certain DOD contracts, as well export control provisions, limit the types of defense work that can be conducted through offshore subsidiaries. Typically, when contract functions required personnel with security clearances, these personnel were hired through the contractor's U.S. subsidiary, while personnel who did not require a security clearance were hired though an offshore subsidiary. For one contract task order we reviewed, more than 80 percent of the contractor's staff were employed by its offshore subsidiary. See table 2 for information on the six contracts selected for review.

¹⁶One of the six case study contractors, Fluor Intercontinental, did not use an offshore subsidiary to support the DOD contract we selected for review. According to DOD and company officials, they also did not use offshore subsidiaries to support other DOD contracts.

Table 2: Contractor and Subsidiary Information for Six Case Study Defense Contracts

Contractor	Services provided	FY2008 Contract obligation ^a (millions)	Offshore subsidiary supports contract	Offshore subsidiary supports other DOD contracts	Offshore subsidiary awarded contract (prime contractor)	Location (for contract reviewed)	Contract place of performance	Contract type
Kellogg Brown and Root Services Incorporated	Logistics support	\$4,901	✓	✓		Cayman Islands	Various countries, including Iraq	Primarily cost-plus
Combat Support Associates	Logistics support	\$487	✓			Cayman Islands	Kuwait	Cost-plus/ award fee
Fluor Intercontinental Incorporated	Architect – engineer services	\$196			Did not use an offshore subsidiary	Iraq	Cost-plus/ award fee	
AECOM Government Services, Incorporated	Maintenance and repair of vehicles	\$143	✓	✓		Cayman Islands	Iraq Afghanistan	Cost-plus/ fixed fee
DynCorp International LLC	Construction of miscellaneous buildings	\$40	✓	✓		United Arab Emirates	Afghanistan	Fixed-price
ITT Federal Services GMBH	Facilities operations and management	\$35	✓	✓ ^b	✓	Germany	Germany	Cost-plus/ award fee

Source: GAO analysis.

^aThe contract dollars obligated value only includes the contract actions for the specified service, per FPDS-NG. This value may not reflect the contract's full obligation amount in cases where the contract has actions under multiple FPDS-NG service categories.

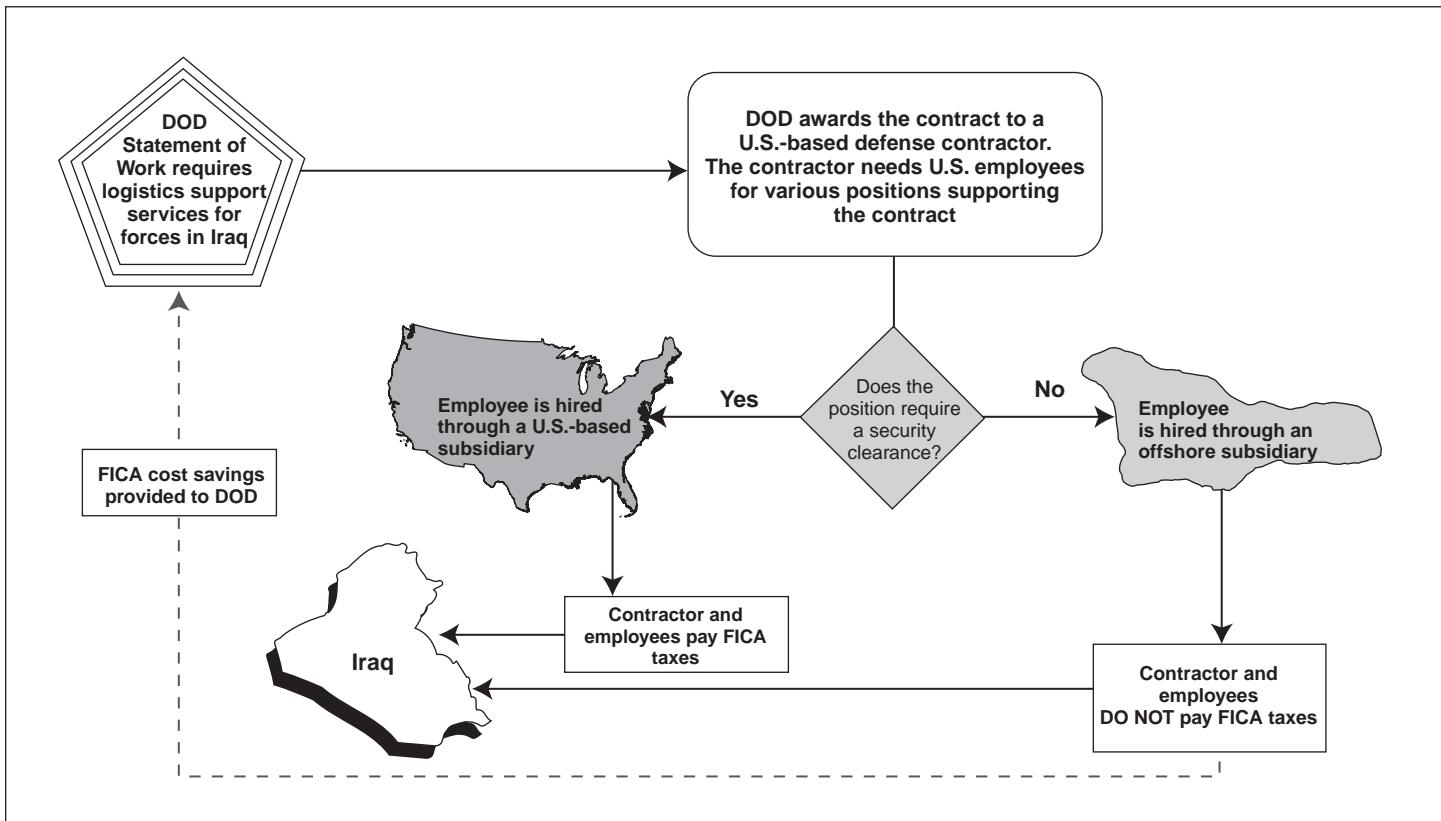
^bITT Federal Services, the parent company of ITT Federal Services GMBH, uses another offshore subsidiary to support DOD contracts.

Three of the six DOD contractors used subsidiaries registered, but that did not have any staff or business activity, in the Cayman Islands. Services were provided in locations near the contract place of performance. For example, one company used two Cayman Islands subsidiaries to hire and pay employees for logistics support contracts performed in locations around the world, including the Middle East. However, the subsidiaries' payroll processing work is conducted in Dubai. According to DOD, these subsidiaries are registered in the Cayman Islands to avoid payroll taxes. One company official explained that the Cayman Islands are a popular choice for establishing offshore subsidiaries because of the ease with which they can be registered due to local laws. Furthermore, employees of Cayman Islands corporations do not pay taxes in that country. Figure 1 provides an example of how defense contractor subsidiaries were used to

hire and pay U.S. personnel for DOD work performed overseas prior to the HEART Act.

For five of the six cases we reviewed, DOD reduced contract costs as a result of the use of offshore subsidiaries to provide payroll functions. Most of the contracts were cost-reimbursement type contracts, which authorize agencies to reimburse contractors for allowable costs to the extent prescribed in the contract. Taxes are a type of allowable cost prescribed in the Federal Acquisition Regulation. Consequently, if defense contractors were required to pay taxes such as FICA or state and federal unemployment insurance, DOD would usually reimburse these costs. Our analysis of the two largest service contracts with a combined total of more than \$6 billion in fiscal year 2008 obligations indicates that DOD saved at least \$110 million per year by not having to provide reimbursement for FICA taxes.

Figure 1: Example of Contractor Process for Hiring U.S. Personnel through Offshore Subsidiaries for DOD Work Overseas Prior to the HEART Act



Source: GAO analysis.

HEART Act Resulted in Contractors Paying FICA Taxes and Impacted Use of Offshore Subsidiaries

After the HEART Act took effect, defense contractors that were not paying FICA taxes on U.S. personnel working on DOD contracts outside of the United States began to submit requests for equitable adjustments to recover their newly increased tax costs. For the four cost-reimbursement contracts we reviewed that used an offshore subsidiary, the increased costs were negotiated with DOD officials and were being processed as contract modifications at the time of our review. DOD and company officials stated that total contract costs have increased by approximately 8 to 10 percent in some cases due to both FICA tax payments and increased contract award fees.¹⁷ As a result, in fiscal year 2009, four of the five

¹⁷Potential contract award fees are based on estimated total contract costs.

contractors using offshore subsidiaries to support DOD work requested reimbursement of at least \$140 million from DOD for new FICA payments on the contracts we reviewed as well as some others.

Several contractors stated that they initially used offshore subsidiaries to hire U.S. workers to perform services overseas in order to offer competitive prices when bidding for DOD contracts, and as this practice grew, it became a competitive necessity. DOD officials said they did not think that using an offshore subsidiary to avoid FICA taxes provided a competitive advantage to companies since each competitor was free to adopt the offshore structure if it chose. With the enactment of the HEART Act, some defense companies have reconsidered the use of offshore subsidiaries to hire U.S. workers. One contractor said it established a subsidiary in 1993 to support a DOD logistics contract because, at that time, company tax advisors proposed using offshore subsidiaries to achieve cost savings that could be passed on to DOD. This contractor is considering whether to continue using this subsidiary now that the cost advantage from FICA tax savings has been removed. Another contractor said that it had transferred U.S. personnel from its Cayman Islands subsidiary to a U.S.-based subsidiary and is evaluating whether to close the subsidiary. A third contractor said that the HEART Act removed the cost advantage when hiring U.S. citizens and residents to perform work overseas, but it still uses the subsidiary to manage foreign workers.

Contractors noted that the requirement of the HEART Act that companies hiring U.S. personnel overseas pay FICA taxes may have unintended consequences, such as hiring fewer of these employees. Additionally, they noted that foreign-based contractors now have a cost advantage in competing for overseas DOD contracts because they are not required to pay FICA taxes for their U.S. workers. Several company and DOD officials also stated that a foreign subsidiary could continue to avoid FICA taxes if the parent company changes its ownership stake in the foreign subsidiary to 50 percent or less, which is below the ownership threshold defined in the law.¹⁸ In fact, one defense contractor adopted this practice and sold 50 percent of its wholly owned subsidiary the day before the HEART Act took effect in order for its foreign subsidiary to avoid paying FICA taxes for

¹⁸The HEART Act applies to foreign companies (and their U.S. workers performing on U.S. government contracts) that are part of a “controlled group of entities” whose common parent is a U.S. corporation. For this purpose, the HEART Act revised the definition of a “controlled group of entities” to lower the ownership threshold of a parent-subsidiary from “at least 80 percent” to “more than 50 percent.” See 26 U.S.C. § 1563(a)(1).

U.S. workers performing DOD work abroad. According to DCAA, another defense contractor proposed subcontracting U.S. workers who do not require security clearances through a new offshore company to bypass the HEART Act requirements.

Defense Contractors' Offshore Subsidiaries Continue to Avoid Unemployment Taxes for Their U.S. Workers

While five of the six contractors in our case studies said that reducing FICA tax payments was the primary reason for using offshore subsidiaries, this practice also allowed the contractors to reduce costs by avoiding state and federal unemployment insurance taxes for U.S. personnel working overseas. For U.S. citizens performing certain work outside the United States, federal law requires only American employers to pay unemployment taxes; foreign subsidiaries are not defined as American employers under the law. The HEART Act did not address unemployment payroll taxes for U.S. personnel working overseas, and while these taxes are much lower than FICA taxes, contractors have been able to continue to avoid them. Our analysis of data from one contractor showed a savings of almost \$6 million in 2009 by not paying state and federal unemployment insurance taxes for U.S. workers on its federal government contract that were hired through its offshore subsidiary. Table 3 provides a notional example of differences in payroll taxes paid for U.S. workers of a domestic subsidiary versus an offshore subsidiary.

Table 3: Notional Comparison of Selected Payroll Taxes Paid by Employer for an Employee Earning \$100,000 in Wages

Employer^a	Offshore subsidiary, before the HEART Act	Offshore subsidiary, after the HEART Act	U.S. subsidiary
Employee wages	\$100,000	\$100,000	\$100,000
FICA taxes			
Social Security Old Age, Survivors, and Disability Insurance (OASDI) (6.2%)	\$0	\$6,200	\$6,200
Medicare Hospital Insurance (1.45%)	\$0	\$1,450	\$1,450
Unemployment taxes			
Federal Unemployment Tax (0.8% on first \$7,000 in wages) ^b	\$0	\$0	\$56
State Unemployment Tax (1% on first \$9,000 in wages) ^c	\$0	\$0	\$90
Total employer payroll taxes	\$0	\$7,650	\$7,796

Source: GAO Analysis

^aWhile both employers and employees pay equal shares of FICA taxes, contributions to federal and state unemployment taxes are usually paid by employers but not by employees.

^bThe federal unemployment tax rate is 6.2% on the first \$7,000 of annual wages, but this is typically reduced to 0.8% through an offset credit for employers who pay the state unemployment tax, resulting in a maximum tax of \$56.00 per employee, per year ($0.008 \times \$7,000 = \56.00).

^cPercentage based on average rate paid by Texas employers in 2009. State unemployment tax rates vary by state and by employer, so that employer rates are based on their experience with the unemployment benefits system. The state tax wage bases also vary, from \$7,000 in several states to more than \$30,000 in others.

In addition to offshore subsidiaries not owing unemployment taxes, their U.S. workers may not be eligible for unemployment benefits stemming from this employment. In one state where four of the six case study contractors have a corporate presence, we reviewed documentation for about 140 former employees of several contractors who were denied unemployment benefits in 2009. State workforce officials indicated that these benefits were denied because the employees worked for a foreign subsidiary and not an American employer.

Contractors' Use of Offshore Subsidiaries Did Not Impede DOD's Contract Oversight

In the contracts we reviewed, DOD oversight officials were aware of the roles that offshore subsidiaries played in supporting the contracts. DOD officials said that oversight mechanisms, such as DCAA's annual reviews of incurred costs, provide knowledge of the activities of offshore subsidiaries in cost-reimbursement contracts. For the contracts for which DCMA had oversight responsibilities, officials said that they reviewed DCAA audits and approved company disclosure statements, which included information about the contractors' use of subsidiaries.

Contracting officials said that the use of offshore subsidiaries did not negatively affect contract schedule or performance.

In the five contracts we reviewed that used offshore subsidiaries, DCAA conducted audits or examined documents related to the specific activities of the subsidiary. For example, for two of the contractors, DCAA conducted on-site audits of the payroll processing activities supported by the offshore subsidiaries. In one case, the contractors' offshore subsidiaries are registered in the Cayman Islands, but its payroll processing services are performed in Dubai and were audited on location by DCAA. One DCAA office that monitors several contractors using offshore subsidiaries has developed guidance to facilitate reviewing the activities of payroll processing functions.

Contract file and oversight documents we reviewed, such as contractor price proposals and cost accounting disclosure statements, disclosed the use of offshore subsidiaries. For example, two of the contract files included contractor labor rates, which specified the payroll company (either onshore or offshore) assigned for each position. The rates also indicate that the fringe benefits paid to employees of the two offshore subsidiaries were less than benefits for U.S.-based employees. In another case, one company's price negotiation memo identified costs related to two offshore subsidiaries, but it did not indicate that they were foreign companies or where they were registered.

Although information on the offshore subsidiaries was disclosed in the contract files, the clarity of information concerning the offshore subsidiaries' role in the contracts we reviewed varied. For example, for one of the contracts, a DCMA official said that information identifying the contractor's offshore subsidiary was available, but it took several months of working with the contractor to confirm the subsidiary's purpose in avoiding FICA taxes. In other contracts we examined, the role of the offshore subsidiary was more readily apparent. For example, one contract file included documents in which the defense contractor described the offshore subsidiary as a means of saving DOD the cost of reimbursing FICA taxes. The contract file indicated that contracting staff reviewed the company's information with Army counsel before consenting to the subcontracting arrangement.

DCAA also has responsibility for reviewing contractor compliance with federal cost accounting standards (CAS). For the six contracts in our review, DCAA officials indicated that the contractors complied with CAS. Contracts and subcontracts executed and performed entirely outside of

the United States, its territories, and possessions are exempt from CAS requirements.¹⁹ Although performed overseas, according to DCAA and contracting officials, most of the contracts we examined were not CAS exempt because some costs were incurred within the United States, and in each case the contractors followed CAS. In general, defense companies said that even when their contracts are CAS exempt, they comply with CAS because the accounting system is already in place.

Conclusion

While defense contractors have increased their offshore subsidiaries used for commercial purposes, the practice of using offshore subsidiaries to avoid certain payroll taxes on U.S. government contracts has been addressed by the HEART Act. As a result, contractors have begun to pay FICA taxes for U.S. workers hired through offshore subsidiaries to support DOD contracts, thus contributing to the Social Security and Medicare Trust Funds. This requirement will likely lead to a change in corporate decisions to create offshore subsidiaries for this purpose. DOD also continues to monitor these contractor practices. Notwithstanding these changes, the HEART Act did not address unemployment taxes for U.S. workers of offshore subsidiaries, and some contractors continue to avoid these taxes. While unemployment insurance taxes are much lower than those for FICA, this continues to allow for a potential tax advantage for contractors hiring U.S. workers through offshore subsidiaries for U.S. government contracts performed overseas.

Matter for Congressional Consideration

Congress should consider whether further legislative actions are needed to require payment of unemployment taxes for U.S. workers hired by offshore subsidiaries to perform services overseas.

Agency Comments and Our Evaluation

We provided a draft of this report to the Departments of Defense and Labor, the Internal Revenue Service, and the Securities and Exchange Commission. Each agency generally agreed with our report and did not provide additional comments. We also obtained third party views from defense contractors selected as part of our case studies; they generally agreed with our findings and provided technical comments, which were

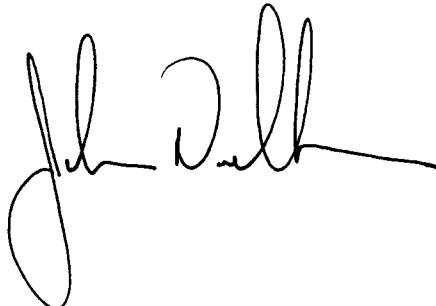
¹⁹48 C.F.R. § 9903.201-1(b)(14).

incorporated as appropriate. Texas Workforce Commission officials reviewed a portion of the draft report related to unemployment benefits and agreed with our findings.

We are sending copies of this report to other interested congressional committees and the Secretary of Defense. In addition, this report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

Should you or your staff have any questions on the matters covered in this report, please contact John Needham at (202) 512-4841 or needhamjk1@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report.

Key contributors to this report were Amelia Shachoy, Assistant Director; W. William Russell; Jennifer Dougherty; Emily Gruenwald; Ami Ballenger; Noah Bleicher; Ken Patton; and Susan Neill.

A handwritten signature in black ink, appearing to read "John K. Needham".

John K. Needham
Director
Acquisition and Sourcing Management

List of Committees

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The Honorable John McCain
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Ike Skelton
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Committee on Armed Services
House of Representatives

Appendix I: Scope and Methodology

To understand the trends and purposes of defense contractors' offshore subsidiaries, we identified 45 contractors with \$1 billion or more in 2008 Department of Defense (DOD) spending, based on data from the Federal Procurement Data System-Next Generation (FPDS-NG).¹ Of the 45 contractors, we found 29 were publicly traded U.S. companies and we corroborated this information with officials at the Securities and Exchange Commission (SEC). We reviewed prior GAO reports, performed literature searches, and conducted legal research regarding DOD contractors' use of offshore subsidiaries.

To identify the 29 companies' subsidiaries, we reviewed the 2008 Form 10-K² reports filed with the SEC, which require companies to disclose their significant subsidiaries. SEC defines a subsidiary as significant if (1) the parent corporation's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the consolidated total assets of the parent corporation and its subsidiaries, (2) the parent corporation's and its other subsidiaries' proportionate share of total assets (after intercompany eliminations) of the subsidiary exceed 10 percent of the consolidated total assets of the parent corporation and its subsidiaries, or (3) the parent corporation and its other subsidiaries' equity in the income from continuing operations exceeds 10 percent of the consolidated income from continuing operations of the parent corporation and its subsidiaries. The total number of subsidiaries reported to the SEC is most likely understated. We also analyzed offshore subsidiary data from 2003 and 2008 for 25 of the 29 contractors to determine differences in the numbers and locations of offshore subsidiaries over a 5-year period. We excluded 4 of the 29 contractors that were not publicly traded in 2003 from our analysis.

To further understand the reasons companies use offshore subsidiaries, we conducted interviews with tax specialists, senior international procurement attorneys, as well as tax and legal professors. We performed literature searches to find examples of legal cases involving the contractors we selected for case studies and their subsidiaries from 1980 to present. We specifically looked for cases involving liability issues between a parent company and an offshore subsidiary.

¹Selection of defense contractors was based on the obligation amounts as of February 2009.

²Form 10-K is used for the annual reports or transition reports that corporations file with the SEC according to the Securities Exchange Act of 1934. 15 U.S.C. §§ 78m, 78o(d); 17 C.F.R. § 249.310.

To learn more about how defense contractors use offshore subsidiaries, we conducted interviews with 13 of the 29 DOD contractors. We selected these contractors based on a range of the amount of government work in fiscal year 2008, location of identified subsidiaries, and industry type. In addition, we interviewed 3 other defense contractors for the case studies we conducted, for a total of 16 contractors interviewed.

We identified the top service categories procured by DOD outside of the United States based on fiscal year 2008 FPDS-NG data. The services selected were logistics support, construction of miscellaneous buildings, facilities operations, repair and maintenance of vehicles, and architect and engineer services. From this data, we selected six contracts for services overseas to provide illustrative examples of services performed outside the United States based on several factors, including the amount of contract dollars obligated, type of service provided, contracting command, and the contract place of performance, as well as services using large numbers of U.S. personnel. We compared the FPDS-NG data to DOD Synchronized Pre-deployment and Operational Tracker (SPOT) data to identify contracts that employed U.S. workers abroad. We also identified contracts in which the prime contractor was an offshore subsidiary of a U.S. defense company. For each contract selected, we interviewed contractor officials, DOD contracting command staff, as well as DOD officials responsible for oversight of the contracts. Of the six contracts that met these selection criteria, three of the associated contractors were among the 13 interviewed from the top 29 defense contractors. Table 4 lists the 16 DOD contractors interviewed.

Table 4: DOD Contractors Interviewed and Their Fiscal Year 2008 DOD Contract Obligations

DOD contractors	Fiscal Year 2008 DOD contract obligations	Fiscal Year 2008 DOD service contract obligations
Lockheed Martin Corporation	\$28.9	\$12.6
The Boeing Company	22.2	9.4
General Dynamics Corporation	15.2	5.1
L-3 Communications Holdings, Inc.	6.8	4.7
KBR, Inc.	6.0	6.0
ITT Corporation	4.6	2.0
General Electric Company	3.5	1.0
Computer Sciences Corporation	2.9	2.9
Health Net, Inc.	2.4	2.4
Harris Corporation	1.8	0.3
Honeywell International, Inc.	1.7	0.7
DynCorp International, Inc.	1.4	1.4
Rockwell Collins, Inc.	1.2	0.3
Fluor Corporation	0.7	0.4
Combat Support Associates	0.5	0.5
AECOM Technology Corporation	0.5	0.5
Total	\$100.3	\$50.1

Source: USASpending and FPDS-NG, August 2009.

To assess the FPDS-NG data reliability for the contracts selected, we corroborated the FPDS-NG data with DOD officials and the contract files. We confirmed that contract information reported in FPDS-NG, including the contract identification number, contract type, service provided, contracted vendors, the contract place of performance, and the fiscal year 2008 dollars obligated were sufficiently reliable for our purposes.

To review DOD oversight and management of defense contractor's use of offshore subsidiaries, for each of the six contracts selected, we reviewed selected contract file documentation, including contracts and task orders, price negotiation memorandums, requests for consent to subcontract, and contractors' proposed pricing data. In addition, we reviewed relevant Defense Contract Audit Agency (DCAA) audit reports and documentation. We also reviewed available guidance from contracting commands and estimates related to implementing the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 and interviewed cognizant DOD officials,

including contracting officers, DCAA and Defense Contract Management Agency (DCMA) where delegated, as well as the contractors. We reviewed the Federal Acquisition Regulation (FAR) and the Defense FAR Supplement to identify any requirements regarding DOD contractors' use of offshore subsidiaries as well as Cost Accounting Standards (CAS) and reviewed DOD's public comments on the CAS Board's review of the CAS exemption for contracts performed entirely overseas.

To determine whether contractors using offshore subsidiaries selected for case studies owed payroll taxes, we reviewed contract file documents for the contractors and interviewed DCAA officials. With regard to state and federal unemployment taxes, we analyzed contractor proposed labor rate information in 2009 to determine the amount of state and federal unemployment tax that was avoided on DOD contracts through the use of offshore subsidiaries. We also selected one state, Texas, in which four of the six selected contractors had a corporate presence as an illustrative example. We reviewed data and interviewed the state's workforce officials to determine whether employees of those companies were denied unemployment benefits in 2009 because the employees were hired through a company's offshore subsidiary. We assessed the reliability of the state unemployment data and determined it was sufficiently reliable for our purposes. In addition, we reviewed guidance and interviewed Department of Labor officials about federal and state unemployment insurance eligibility requirements.

We conducted this performance audit from February 2009 through January 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Related GAO Products

International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions. [GAO-09-157](#). Washington, D.C.: December 18, 2008.

U.S. Multinational Corporations: Effective Tax Rates are Correlated with Where Income Is Reported. [GAO-08-950](#). Washington D.C.: August 12, 2008.

DCAA Audits: Allegations That Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated. [GAO-08-857](#). Washington D.C.: July 22, 2008.

Cayman Islands: Business and Tax Advantages Attract U.S. Persons and Enforcement Challenges Exist. [GAO-08-778](#). Washington D.C.: July 24, 2008.

Defense Acquisitions: DOD's Increased Reliance on Service Contractors Exacerbates Long-standing Challenges. [GAO-08-621T](#). Washington, D.C.: January 23, 2008.

Offshoring: U.S. Semiconductor and Software Industries Increasingly Produce in China and India. [GAO-06-423](#). Washington D.C.: September 7, 2006.

Company Formations: Minimal Ownership Information Is Collected and Available. [GAO-06-376](#). Washington, D.C.: April 7, 2006.

International Trade: Current Government Data Provide Limited Insight into Offshoring of Services. [GAO-04-932](#). Washington D.C.: September 22, 2004.

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